

International Finance

Module 4, 2017-2018

Instructor: Konstantin Styrin

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Course information

Course Website: my.nes.ru

Instructor's Office Hours: by appointment; walk-ins welcome

Class Time: TBA

Room Number: TBA

TA: Andrei Malokostov

Course description

This course is an introduction to international finance, a.k.a. open economy/international macroeconomics. Its main goal is to give the students the broad view of the issues studied in this field. It applies familiar macro modeling tools to the open economy to study such phenomena as exchange rates dynamics, international propagation of macroeconomic shocks, etc. The course starts by extending the workhorse business cycle macroeconomic model to the open economy environment and examining how far different versions of the extended model can go in explaining main empirical facts about international business cycles. We then turn to the question to what extent investors take advantage of the access to the international capital market in order to diversify away country-specific risks. We discuss alternative explanations to the home bias in asset portfolios puzzle, the tendency of real-world national portfolios to allocate disproportionately greater shares of wealth toward domestic assets. Our next task is to understand the causes of global imbalances, a situation where some economies such as the U.S. tend to run trade deficits and thus accumulate net external liabilities whereas others such as China and oil-exporting countries (including Russia) tend to run trade surpluses and thus accumulate net external assets. This pattern tends to persist over time, which appears to contradict the notion of intertemporal trade. One force that delivers external adjustment in the presence of global imbalances is the valuation effect. Once almost all U.S. external liabilities are denominated in the U.S. dollars whereas most of its external assets in the foreign currency, a depreciation of the U.S. dollar will reduce the external debt burden of the U.S. economy. The depreciation of the U.S. currency should also accompany the classic, trade channel of external adjustment that works through expenditure switching toward domestic goods away from imported goods thus pushing the trade balance from deficit to surplus. The extent to which this channel is operational depends on the degree of the exchange rate pass-through, i.e. how fast changes in the exchange rate translate into domestic prices of imported goods. This brings us to the discussion of international goods prices and the real exchange rate in the fourth part of the course. Part V surveys theoretical and empirical literature on

macroeconomic determinants of floating exchange rates, a key open macro variable. One robust empirical finding in this literature is that short-term dynamics of exchange rates seem to be disconnected to the behavior of their macro fundamentals (such as relative output or money supplies) as predicted by standard open macro models. Another remarkable manifestation of the exchange rate disconnect is poor performance of structural macro model to outperform naïve benchmarks (a simple random walk model) in forecasting exchange rates out of sample. Part VI focuses on the explanation of the well-documented empirical failure of the Uncovered Interest Parity. The latter is the statement that, in equilibrium, a positive difference between home and foreign interest rate should be equal to the expected depreciation of the home currency, which makes the investor indifferent between investing into home and foreign assets. The failure of the UIP suggests that the investment strategy known as carry trade, which is to borrow in a low-interest currency and lend in a high-interest currency should be profitable in expectation. We consider alternative explanations of positive excess returns on carry trade, from conventional risk factors in consumption-based asset-pricing models to various kinds of frictions such as segmented financial markets, information costs that give rise to occasional rebalancing of asset portfolios, overconfidence, etc. Part VII studies sovereign debt and sovereign defaults. The central question here is what forces sovereign governments to honor their external debt (most of the time). Part VIII deals with international financial crises with the emphasis of the most recent global financial crisis, which triggered the Great Recession 2007-2009, and the Eurozone debt crisis. The final part of the course is related to another classic open macro question why capital does not flow from rich to poor countries.

Course requirements, grading, and attendance policies

The requirements include the midterm exam (40% of the final grade), and the final exam (60%). Three of four problem sets will be distributed for practice purposes only, without contributing to the course grade. At least 70% lecture attendance is mandatory for getting a passing grade.

Course contents

I. International Business Cycles

- Implications of standard dynamic open-economy model and empirical facts.
- Consumption (un)correlation puzzle. Backus-Smith puzzle.
- Potential role of transportation costs, financial market incompleteness, and demand shocks.

II. International Asset Portfolios

- Home bias in asset portfolios puzzle.
- Potential role of endogenous terms of trade and transportation costs.
- Non-capitalizable income and endogenous investment/payout decisions.

III. Global Current Account Imbalances

- Old and new views on current account imbalances.
- Bretton Woods II.
- Uneven financial development across countries and global imbalances.

- Role of demographic cross-county differences.
- Valuation channel of external adjustment.

IV. International Goods Prices and Real Exchange Rate

- Exchange rate pass-through into imports prices.
- PPP puzzle.

V. Exchange Rate Disconnect

- Do macro fundamentals forecast exchange rates?
- Do exchange rates forecast their fundamentals?

VI. Time-Varying Risk and Forward Premium Puzzle (FPP)

- Empirical failure of the Uncovered Interest Parity at short time horizons.
- Do conventional risk factors explain excess returns on carry trade?
- Alternative explanations of PPP: segmented financial markets; leveraged speculative trading and currency crashes; infrequent portfolio rebalancing decisions; overconfidence.

VII. Sovereign debt

- What makes countries willing to repay their debts? What price does a country pay for defaulting on its debt?

VIII. International financial crises

- Models of currency, banking, and sovereign debt crises
- Financial contagion
- The global financial crisis and the Great Recession 2007-2009.
- The Eurozone crisis.

IX. Global Capital Market Integration: Emerging Markets and Developing Countries (if time permits)

- Financial openness and economic performance.
- Why does capital not flow from North to South?
- Sudden stops.

Sample tasks for course evaluation

Past exams will be posted on my.nes.ru

Course materials

Required textbooks and materials

Obstfeld, M., and K. Rogoff, *Foundations of International Macroeconomics*, MIT Press, 1996, selected chapters.

Gopinath, G., E. Helpman, and K. Rogoff (eds.), *Handbook of International Economics*, volume 4, Elsevier North Holland, 2014, selected chapters.

Additional materials

Will be posted on my.nes.ru.

Academic integrity policy

Cheating, plagiarism, and any other violations of academic ethics at NES are not tolerated.